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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-119890-18]

RIN 1545-BO92

Section 42, Low-Income Housing Credit Average Income Test Regulations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations setting forth guidance on the average income test under section 42(g)(1)(C) of the Internal Revenue Code (Code) for purposes of the low-income housing credit. These proposed regulations affect owners of low-income housing projects, tenants in those projects, and State or local housing credit agencies that administer the low-income housing credit.

DATES: Written (including electronic) comments must be received by [**INSERT DATE 60 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER**].

ADDRESSES: Commenters are strongly encouraged to submit public comments electronically. Submit electronic submissions via the Federal eRulemaking Portal at www.regulations.gov (indicate IRS and REG-104591-18) by following the online instructions for submitting comments. Once submitted to the Federal eRulemaking Portal, comments cannot be edited or withdrawn. The IRS expects to have limited personnel available to process public comments that are submitted on paper through the mail. Until further notice, any comments submitted on paper will be considered to the extent practicable. The Department of the Treasury (Treasury Department) and the

IRS will publish for public availability any comment submitted electronically, and to the extent practicable on paper, to its public docket.

FOR FURTHER INFORMATION CONTACT: Concerning these proposed regulations, Dillon Taylor or Michael J. Torruella Costa at (202) 317-4137; concerning submissions of comments, Regina L. Johnson at (202) 317-6901 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) under section 42 of the Code.

The Tax Reform Act of 1986, Pub. L. 99-514, 100 Stat. 2085 (1986 Act) created the low-income housing credit under section 42 of the Code. Section 42(a) provides that the amount of the low-income housing credit for any taxable year in the credit period is an amount equal to the applicable percentage of the qualified basis of each qualified low-income building.

Section 42(c)(1)(A) provides that the qualified basis of any qualified low-income building for any taxable year is an amount equal to (i) the applicable fraction (determined as of the close of the taxable year) of (ii) the eligible basis of the building (determined under section 42(d)). Sections 42(c) and 42(d) define applicable fraction and eligible basis. Section 42(d)(1) and (2) define the eligible basis of a new building or an existing building, respectively.

Section 42(c)(2) defines a qualified low-income building as any building which is part of a qualified low-income housing project at all times during the compliance period (that is, the period of 15 taxable years beginning with the first taxable year of the credit period) and to which the amendments made by section 201(a) of the 1986 Act apply (generally property placed in service after December 31, 1986, in taxable years ending after that date). To qualify as a low-income housing project, one of the section 42(g) minimum set-aside tests, as elected by the taxpayer, must be satisfied.

Prior to the enactment of the Consolidated Appropriations Act of 2018, Pub. L. 115-141, 132 Stat. 348 (2018 Act), section 42(g) set forth two minimum set-aside tests that a taxpayer may elect with respect to a low-income housing project, known as the 20-50 test and the 40-60 test. Under the 20-50 test, at least 20 percent of the residential units in the project must be both rent-restricted and occupied by tenants whose gross income is 50 percent or less of the area median gross income (AMGI). Section 42(g)(1)(A). Under the 40-60 test, at least 40 percent of the residential units in the project must be both rent-restricted and occupied by tenants whose gross income is 60 percent or less of AMGI. Section 42(g)(1)(B).

Section 103(a) of Division T of the 2018 Act added section 42(g)(1)(C) to the Code to provide a third minimum set-aside test that a taxpayer may elect with respect to a low-income housing project: the average income test. Section 42(g)(1)(C)(i) provides that, a project meets the minimum requirements of the average income test if 40 percent or more (25 percent or more in the case of a project described in section 142(d)(6)) of the residential units in the project are both rent-restricted and occupied by tenants whose income does not exceed the imputed income limitation designated by the taxpayer with respect to the respective unit. Section 42(g)(1)(C)(ii)(I) and (III) provides that the taxpayer must designate the imputed income limitation for each unit and the designated imputed income limitation of any unit must be 20, 30, 40, 50, 60, 70, or 80 percent of AMGI. Section 42(g)(1)(C)(ii)(II) provides that the average of the imputed income limitations designated by the taxpayer for each unit must not exceed 60 percent of AMGI.

Generally, under section 42(g)(2)(D)(i), if the income of the occupant of a low-income unit rises above the income limitation, the unit continues to be treated as a low-income unit if the income of the occupant initially met the income limitation and the unit continues to be rent-restricted. Section 42(g)(2)(D)(ii), however, provides an exception to the general rule in case of the 20-50 test or the 40-60 test. Under this exception, the unit ceases to be treated as a low-income unit when two conditions occur. The first condition is that the income of an occupant of a low-income unit increases above 140 percent of the imputed income limitation applicable to the unit under section 42(g)(1) (applicable income limitation). The second condition is that a new occupant, whose income exceeds the applicable income limitation, occupies any residential unit in the building of a comparable or smaller size. In the case of a deep rent skewed project described in section 142(d)(4)(B), “170 percent” is substituted for “140 percent” in applying the applicable income limitation under section 42(g)(1), and the second condition is that any low-income unit in the building is occupied by a new resident whose income exceeds 40 percent of AMGI. Section 42(g)(2)(D)(iv). The exception contained in section 42(g)(2)(D)(ii) is referred to as the “next available unit rule.” *See also* §1.42-15 of the Income Tax Regulations.

Section 103(b) of Division T of the 2018 Act added section 42(g)(2)(D)(iii), (iv) and (v) to the Code to provide a new next available unit rule for situations in which the taxpayer has elected the average income test. Under this new next available unit rule, a unit ceases to be a low-income unit if two conditions are met. The first condition is whether the income of an occupant of a low-income unit increases above 140 percent of the greater of (i) 60 percent of AMGI, or (ii) the imputed income limitation designated by the taxpayer with respect to the unit (applicable imputed income limitation). The second condition is whether any other residential rental unit in the building that is of a size comparable to, or smaller than, that unit is occupied by a new tenant whose income exceeds the applicable imputed income limitation. If the new tenant occupies a unit that was taken into account as a low-income unit prior to becoming vacant, the applicable imputed income limitation is the limitation designated with respect to the unit. If the new tenant occupies a market-rate unit, the applicable imputed income limitation is the limitation that would have to be designated with respect to the unit in order for the project to continue to maintain an average of the designations of 60 percent of AMGI or lower.

In the case of a deep rent skewed project described in section 142(d)(4)(B) for which the taxpayer elects the average income test, “170 percent” is substituted for “140 percent” in applying the applicable imputed income limitation, and the second condition is that any low-income unit in the building is occupied by a new resident whose income exceeds the lesser of 40 percent of AMGI or the imputed income limitation designated with respect to the unit under section 42(g)(1)(C)(ii)(I). Section 42(g)(2)(D)(iv).

Under section 42(g), once a taxpayer elects to use a particular set-aside test with respect to a low-income housing project, that election is irrevocable. Thus, if a taxpayer had previously elected to use the 20-50 test under section 42(g)(1)(A) or the 40-60 test under section 42(g)(1)(B) with respect to a low-income housing project, the taxpayer may not subsequently elect to use the average income test under section 42(g)(1)(C) with respect to that low-income housing project. Section 42(g)(4) provides generally that section 142(d)(2) applies for purposes of determining whether any project is a qualified low-income housing project and whether any unit is a low-income unit.

Section 42(m)(1) provides that the owners of an otherwise-qualifying building are not entitled to the housing credit dollar amount that is allocated to the building unless, among other requirements, the allocation is pursuant to a qualified allocation plan (QAP). A QAP provides standards by which a State or local housing credit agency (Agency) is to make these allocations. Under §1.42-5(a)(1), a QAP must contain a procedure that the Agency will follow in monitoring noncompliance.

Explanation of Provisions

I. Proposed §1.42-15, Next Available Unit Rule for the Average Income Test

The proposed regulations update the next available unit provisions in §1.42-15 to reflect the new set-aside based on the average income test and to take into account section 42(g)(2)(D)(iii), (iv) and (v). In situations where multiple units are over-income at the same time in an average-income project that has a mix of low-income and market-rate units, these regulations provide that a taxpayer need not comply with the next available unit rule in a specific order. Instead, renting any available comparable or smaller vacant unit to a qualified tenant maintains the status of all over-income units as low-income units until the next comparable or smaller unit becomes available (or, in the case of a deep rent skewed project, the next low-income unit becomes available). For example, in a 20-unit building with 9 low-income units (3 units at 80 percent of AMGI; 2 units at 70 percent of AMGI; 1 unit at 40 percent of AMGI; and 3 units at 30 percent of AMGI), if there are two over-income units, one a 30 percent income 3-bedroom unit and another a 70 percent 2-bedroom unit, and the next available unit is a vacant 2-bedroom market-rate unit, renting the vacant 2-bedroom unit to occupants at either the 30 or 70 percent income limitation would satisfy both the minimum set-aside of 40 percent and the average test of 60 percent or lower required by section 42(g)(1)(C).

II. Proposed §1.42-19, Average Income Test

A. In General

The proposed regulations provide that a project for residential rental property meets the requirements of the average income test under section 42(g)(1)(C) if 40 percent or more (25 percent or more in the case of a project described in section 142(d)(6)) of the residential units in the project are both rent-restricted and occupied by tenants whose income does not exceed the imputed income limitation designated by the taxpayer with respect to the respective unit. The average of the designated imputed income limitations of the low-income units in the project must not exceed 60 percent of AMGI.

B. Designation of Imputed Income Limitations

Section 42(g)(1)(C)(ii) provides special rules relating to the income limitations applicable in the average income test. Specifically, it provides that the taxpayer must designate the imputed income limitation for each unit taken into account under the average income test. Further, the imputed income limitation of any unit designated must be 20, 30, 40, 50, 60, 70, or 80 percent of AMGI.

The proposed regulations provide that a taxpayer must designate the imputed income limitation of each unit taken into account under the average income test in accordance with: (1) any procedures established by the IRS in forms, instructions, or publications or in other guidance published in the Internal Revenue Bulletin pursuant to §601.601(d)(2)(ii)(b); and (2) any procedures established by the Agency that has jurisdiction over the low-income housing project that contains the units to be designated, to the extent that those Agency procedures are consistent with any IRS guidance and these regulations. After the enactment of the 2018 Act, commenters have specifically asked that Agencies be provided this flexibility, and the Treasury Department and the IRS agree that Agencies should generally be able to establish designation procedures that accommodate their needs. Several commenters suggested allowing the Agencies, when they consider it necessary, to require income recertifications, to set compliance testing periods, or to adjust compliance monitoring fees to reflect the additional costs associated with monitoring income averaging. These proposed regulations do not change existing levels of flexibility on those issues.

C. Method and Timing of Unit Designation

The Code does not specify the manner by which taxpayers must designate the imputed income limitation of units for purposes of the average income test. Designation of the imputed income limitation with respect to a unit is, first, for Agencies to evaluate the proper mix of units in a project in making housing credit dollar amount allocations consistent with the State policies and procedures set forth in the QAPs, and, second, to carry out their compliance-monitoring responsibilities. For these reasons, the proposed regulations provide that the taxpayers should designate the units in accordance with the Agency procedures relating to such designations, provided that the Agency procedures are consistent with any requirements and procedures relating to unit designation that the IRS may set forth in its forms and publications and other guidance. Further, to promote certainty, the proposed regulations provide that the taxpayers must complete the initial designation of all of the units taken into account for the average income test as of the close of the first taxable year of the credit period. In addition, the proposed regulations provide that no change to the designated imputed income limitations may be made.

D. Requirement to Maintain 60 Percent AMGI Average Test and Opportunity to Take Mitigating Actions

A low-income housing project must meet the requirements of the elected set-aside test for each taxable year. For a project electing the average income test, in addition to the project containing at least 40 percent low-income units, the designated imputed income limitations of the project must meet the requirement of an average test. That is, the average of the designated imputed income limitations of all low-income units (including units in excess of the minimum 40 percent set-aside) must be 60 percent of AMGI or lower (60-percent or lower average test). Regardless of their other attributes, residential units that are not included in the computation of the average do not count as low-income units. Consistent with the application of the 20-50 test and 40-60 test, the statutory requirements of a set-aside test do not change from year to year. Accordingly, in each taxable year, the average of all of the designations must be 60 percent of AMGI or lower.

The Treasury Department and the IRS recognize that, in some situations, the average income requirement may magnify the adverse consequences of a single unit's failure to maintain its status as a low-income unit. Assume, for example, a 100 percent low-income project in which a single unit is taken out of service. Under the 20–50 or 40–60 set-asides, the project remains a qualified low-income housing project even though the reduction in qualified basis may trigger a corresponding amount of recapture. By contrast, under the average income set-aside, if the failing unit has a designated imputed income limitation that is less than 60 percent of AMGI, the average of the limitations without that unit may now be more than 60 percent. In the absence of some relief provision under the average income test, the entire project would fail, and the taxpayer would experience a correspondingly large recapture.

Because there is no indication that the statute intended such a stark disparity between the average income set-aside and the existing 20–50 and 40–60 set asides, the proposed regulations provide for certain mitigating actions. In most situations, if the taxpayer takes a mitigating action within 60 days of the close of a year for which the average income test might be violated, the taxpayer avoids total disqualification of the project and significantly reduces the amount of recapture. See part II.F. of this Explanation of Provisions.

Responding to that same concern after the enactment of the 2018 Act, some commenters asked that Agencies be provided a specific grant of authority to establish procedures and policies related to the average income set-aside that could reduce the risk of failure of an entire project. For example, some commenters asked that Agencies be allowed to establish rules permitting owners to alter the imputed income limitations designated for particular units (presumably by reducing income limitations when needed to maintain a compliant average and then later raising limitations to prevent a permanent reduction in the aggregate maximum gross rents from the project). As described in part II.C. of this Explanation of Provisions, these proposed regulations do not permit designated imputed income limitations to be changed. Other commenters proposed allowing owners to take protective steps similar to those that are provided in the proposed regulations.

E. Results Following an Opportunity to Take Mitigating Actions

The proposed regulations provide that, after any mitigating actions, if, prior to the end of the 60th day following the year in which the project would otherwise fail the 60-percent or lower average test, the project satisfies all other requirements to be a qualified low-income housing project, then as a result of the mitigating action, the project is treated as having satisfied the 60-percent or lower average test at the close of the immediately preceding year. However, if no mitigating actions are taken, the project fails to be a qualified low-income housing project as of the close of the year in which the project fails the average income test.

F. Description of Mitigating Actions

The proposed regulations describe two possible mitigating actions. First, the taxpayer may convert one or more market-rate units to low-income units. Immediately prior to becoming a low-income unit, that unit must be vacant or occupied by a tenant who qualifies for residence in a low-income unit (or units) and whose income is not greater than the new imputed income limitation of that unit (or units).

Alternatively, the taxpayer may identify one or more low-income units as "removed" units. A unit may be a removed unit only if it complies with all the requirements of section 42 to be a low-income unit.

G. Tax Treatment of Removed Units

The proposed regulations provide that a removed unit is not included in computing the average of the imputed income limitations of the low-income units under the 60-percent or lower average test. If the absence of one or more removed units from the computation causes fewer than 40 percent (or, if applicable, fewer than 25 percent) of the residential units to be taken into account in computing the average, the project fails to be a qualified low-income housing project. In addition, a removed unit is not treated as a low-income unit (or units) for purposes of credit calculation. On the other hand, for purposes of the recapture provisions of section 42(j), a removed unit is treated the same as a low-income unit, and thus the act of identifying a removed unit does not trigger recapture (unless the identification reduces the low-income units below 40 percent of the project).

H. Request for Comments on an Alternative Mitigating Action Approach

Recognizing that this approach of mitigating actions may in certain cases cause a project to have less than 40 percent of low-income units and, thereby, to fail the average income test, the Treasury Department and the IRS request comments on an alternative mitigating approach. Under this alternative mitigating approach, in the event that the average test rises above 60 percent of AMGI as of the close of a taxable, due to a low-income unit or units ceasing to be treated as a low-income unit or units, the taxpayer may take the mitigating actions of redesignating the imputed income limitation of a low-income unit to return the average test to 60 percent of AMGI or lower. If, under this approach, a redesignation causes a low-income unit to be an over-income unit as defined in §1.42-15(a), the taxpayer would be required to apply the next available unit rule applicable to the average income test.

Proposed Applicability Date

The amendments to the next available unit regulations in §1.42-15 are proposed to apply to occupancy beginning 60 or more days after the date those regulations are published as final regulations in the **Federal Register**. The average income test regulations in §1.42-19 are proposed to apply to taxable years beginning after the date those regulations are published as final regulations in the **Federal Register**. Taxpayers, however, may rely on the proposed amendments to §1.42-15 for occupancy beginning after [**INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER**] and on or before 60 days after the date those regulations are published as final regulations in the **Federal Register**, provided the taxpayer follows the rules in proposed §1.42-15 in their entirety, and in a consistent manner. Taxpayers may also rely on proposed §1.42-19 for taxable years beginning after **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]** and on or before the date those regulations are published as final regulations in the **Federal Register**, provided the taxpayer follows the rules in proposed §1.42-19 in their entirety, and in a consistent manner.

Special Analyses

This regulation is not subject to review under section 6(b) of Executive Order 12866 pursuant to the Memorandum of Agreement (April 11, 2018) between the Department of the Treasury and the Office of Management and Budget regarding review of tax regulations.

Pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6), it is hereby certified that this regulation will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that, prior to the publication of this regulation and before the enactment of the 2018 Act, taxpayers were already required to satisfy either the 20-50 test or the 40-60 test, as elected by the taxpayer, in order to qualify as a low-income housing project. The 2018 Act added a third minimum set-aside test, the average income test, that taxpayers may elect. This regulation sets forth requirements for the average income test, and the costs associated with the average income test are similar to the costs associated with the 20-50 test and 40-60 test. Accordingly, the Secretary certifies that this regulation will not have a significant economic impact on a substantial number of small entities.

Pursuant to section 7805(f) of the Internal Revenue Code, these regulations will be submitted to the Chief Counsel for the Office of Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for a Public Hearing

Before these proposed amendments to the regulations are adopted as final regulations, consideration will be given to comments that are submitted timely to the IRS as prescribed in the preamble under the “ADDRESSES” section. The Treasury Department and the IRS request comments on all aspects of the proposed regulations. Any electronic comments submitted, and to the extent practicable any paper comments submitted, will be made available at www.regulations.gov or upon request.

A public hearing will be scheduled if requested in writing by any person who timely submits electronic or written comments. Requests for a public hearing are also encouraged to be made electronically. If a public hearing is scheduled, notice of the date and time for the public hearing will be published in the **Federal Register**. Announcement 2020-4, 2020-17 IRB 1, provides that until further notice, public hearings conducted by the IRS will be held telephonically. Any telephonic hearing will be made accessible to people with disabilities.

Drafting Information

The principal authors of these regulations are Dillon Taylor and Michael J. Torruella Costa, Office of the Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the Treasury Department and the IRS participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding in numerical order an entry for §1.42-19 to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.42-19 also issued under 26 U.S.C. 42(n).

* * * * *

Par. 2. Section 1.42-0 is amended by:

1. In §1.42-15:

i. Revising the entry for (c).

ii. Adding entries for (c)(1) and (2) and (c)(2)(i) through (iv).

iii. Revising the entry for (i).

iv. Adding entries for (i)(1) and (2).

2. Adding §1.42-19.

The revisions and additions read as follows:

(ii) Analysis.
(A) Average income test.
(B) Recapture.
(C) Restoration of habitability and of qualified basis.
(h) Applicability dates.

Par. 3. Section 1.42-15 is amended by:

1. Revising the definition of *Over-income unit* in paragraph (a).

2. Revising the heading for paragraph (c).

3. Designating the text of paragraph (c) as paragraph (c)(1) and adding a heading for newly designated paragraph (c)(1).

3. Adding paragraph (c)(2).

4. Revising paragraph (i).

The revisions and additions read as follows:

<u>§1.42-15 Available unit rule</u>.

(a)* * *

Over-income unit means, in the case of a project with respect to which the taxpayer elects the requirements of section 42(g)(1)(A) (20-50 test) or section 42(g)(1)(B) (40–60 test), a low-income unit in which the aggregate income of the occupants of the unit increases above 140 percent of the applicable income limitation under section 42(g)(1)(A) and (B), or above 170 percent of the applicable income limitation for deep rent skewed projects described in section 142(d)(4)(B). In the case of a project with respect to which the taxpayer elects the requirements of section 42(g)(1)(C) (average income test), *over-income unit* means a low-income unit in which the aggregate income of the occupants of the unit increases above 140 percent (170 percent in case of deep rent skewed projects described in section 142(d)(4)(B)) of the greater of 60 percent of area median gross income or the imputed income limitation designated with respect to the unit under §1.42-19(b).

* * * * *

(c) Exceptions--(1) Rental of next available unit in case of the 20–50 test or 40–60 test.* * *

(2) Rental of next available unit in case of the average income test--(i) Basic rule. In the case of a project with respect to which the taxpayer elects the average income test, if a unit becomes an over-income unit within the meaning of paragraph (a) of this section, that unit ceases to be a low-income unit if—

(A) Any residential rental unit (of a size comparable to, or smaller than, the over-income unit) is available, or subsequently becomes available, in the same low-income building; and

(B) That available unit is occupied by a new resident whose income exceeds the limitation described in paragraph (c)(2)(iv) of this section.

(ii) No requirement to comply with the next available unit rule in a specific order. In situations where multiple units in a building are over-income units at the same time, it is not necessary for a taxpayer to comply with the rule in this section (next available unit rule) in a specific order.

(iii) Deep rent skewed projects. In the case of a project described in section 142(d)(4)(B) with respect to which the taxpayer elects the average income test, if a unit becomes an over-income unit within the meaning of paragraph (a) of this section, that unit ceases to be a low-income unit if—

(A) Any low-income unit is available, or subsequently becomes available, in the same low-income building; and

(B) That unit is occupied by a new resident whose income exceeds the lesser of 40 percent of area median gross income or the imputed income limitation designated with respect to that unit.

(iv) Limitation. For purposes of paragraph (c)(2) of this section (basic next available unit rule for the average income test), the limitation described in this paragraph (c)(2)(iv) is—

(A) In the case of a unit that was taken into account as a low-income unit prior to becoming vacant, the imputed income limitation designated with respect to that available unit for the average income test under §1.42-19(b); and

(B) In the case of any other unit, the highest imputed income limitation that could be designated with respect to that available unit under §1.42-19(e)(1), in order for the project to continue to meet the requirements of §1.42-19(a)(3) (60 percent of AMGI or less).

* * * * *

(i) Applicability dates--(1) In general. Except as provided in paragraph (i)(2) of this section, this section applies to leases entered into or renewed on and after September 26, 1997.

(2) Applicability dates under the average income test. The second sentence of the definition of *over-income unit* in paragraph (a) of this section and paragraph (c)(2) of this section apply to occupancy beginning 60 or more days after [date these regulations are published as final regulations in the **Federal Register**].

Par. 4. Section 1.42-19 is added to read as follows:

§1.42-19 Average income test.

(a) In general. A project for residential rental property meets the requirements of section 42(g)(1)(C) (average income test) if—

(1) 40 percent or more (25 percent or more in the case of a project described in section 142(d)(6)) of the residential units in the project are both rent-restricted and occupied by individuals whose income does not exceed the imputed income limitation designated by the taxpayer with respect to the respective unit;

(2) The taxpayer designates these imputed income limitations in the manner provided by paragraph (b) of this section; and

(3) The average of the imputed income limitations of the low-income units in the project does not exceed 60 percent of area median gross income (AMGI).

(b) Designation of imputed income limitations--(1) 10-percent increments. The designated imputed income limitation of any unit must be 20 percent, 30 percent, 40 percent, 50 percent, 60 percent, 70 percent, or 80 percent of AMGI.

(2) Method of designation. The taxpayer must designate the imputed income limitation of each unit in accordance with—

(i) Any procedures established by the Internal Revenue Service (IRS) in forms, instructions, or publications or in other guidance published in the Internal Revenue Bulletin pursuant to §601.601(d)(2)(ii)(b) of this chapter; and

(ii) Any procedures established by the State or local housing credit agency (Agency) that has jurisdiction over the low-income housing project that contains the units to be designated, to the extent that those Agency procedures are consistent with the requirements of paragraph (b)(2)(i) of this section.

(3) Timing of designation. Except as provided in paragraph (b)(3)(ii) of this section, not later than the close of the first taxable year of the credit period, the taxpayer must designate the imputed income limitation of each unit taken into account for purposes of paragraph (a) of this section.

(i) No subsequent change to imputed income limitations. No change to the designated imputed income limitations may be made. Even if the taxpayer elects to identify a low-income unit as a removed unit under paragraph (e)(2) of this section, the designated imputed income limitation of the unit is not changed. If a designation is removed, the unit ceases to be a low-income unit.

(ii) Converted market-rate units. If a residential unit that was not a low-income unit is converted to a low-income unit, the designation of the imputed income limitation for that unit must take place on or before the 60th day after the unit is to be treated as a low-income unit. See paragraphs (b)(1) and (2) of this section for rules regarding designation.

(c) Opportunity to take mitigating actions. The taxpayer may take one or more of the mitigating actions described in paragraph (e)(1) or (2) of this section if—

(1) At the close of a taxable year (failing year), one or more low-income units have ceased to qualify as low-income units; and

(2) This cessation causes the project of which they are a part to fail to satisfy the requirement in paragraph (a)(3) of this section (regarding the average of the imputed income limitations of the low-income units).

(d) Results following an opportunity to take mitigating actions. (1) After any mitigating actions, if, prior to the end of the 60th day following the failing year, the project satisfies the requirements to be a low-income housing project (including satisfaction of the requirement in paragraph (a)(3) of this section), then paragraph (a)(3) of this section is treated as having been satisfied at the close of the failing year.

(2) If paragraph (d)(1) of this section does not apply, the project fails to be a qualified low-income project on the close of the failing year.

(e) Mitigating actions--(1) Conversion of a market-rate unit. The taxpayer may convert to low-income status a unit that is not currently a low-income unit. Immediately prior to becoming a low-income unit, the unit must be vacant or occupied by a tenant who qualifies for residence in a low-income unit and whose income is not greater than the imputed income limitation designated by the taxpayer for that unit. This inclusion of conversions as mitigating actions is without prejudice to the permissibility of conversions in other contexts.

(2) Removing low-income units from the average income computation. The taxpayer may identify one or more residential units as *removed units*. A unit may be a removed unit only if it complies with all requirements of section 42 to be a low-income unit. Status as a removed unit may be ended by the taxpayer at any time. Identification of a removed unit and termination of that identification must be effected as provided by the IRS in forms, publications, and guidance published in the Internal Revenue Bulletin pursuant to §601.601(d)(2)(ii)(b) of this chapter. In the absence of any such IRS requirements, the identification and termination must be made in accordance with any Agency procedures.

(f) Tax treatment of removed units--(1) Status of the project. A removed unit is not taken into account under paragraph (a)(3) of this section in computing the average of the imputed income limitations of the low-income units. If the absence of one or more removed units from the computation causes fewer than 40 percent (or, if applicable, fewer than 25 percent) of the residential units to be taken into account in computing the average, the project fails to be a qualified low-income housing project.

(2) Recapture. For purposes of applying section 42(j), removed units are taken into account in the same manner as low-income units. Thus, during the compliance period, a unit's status as a removed unit does not reduce the applicable fraction of section 42(c)(1)(B) and thus does not reduce qualified basis for purposes of recapture under section 42(j).

(3) Amount of credit. For purposes of section 42(a), removed units are not taken into account as low-income units. Thus, during the credit period, a unit's status as a removed unit reduces the applicable fraction—and thus reduces qualified basis—for purposes of calculating the taxpayer's annual credit amount.

(4) Long-term commitment. For purposes of applying section 42(h)(6)(B)(i) to any taxable year after the credit period, removed units are not taken into account as low-income units.

(g) Examples. The operation of this section is illustrated by the following examples.

(1) Example 1--(i) Facts. (A) A single-building housing project received an allocation of housing credit dollar amount. The taxpayer who owns the project elects the average income test, intending for the 5-unit building to have100 percent low-income occupancy. The taxpayer properly and timely designates the imputed income limitations for the 5 units as follows: 2 units at 40 percent of AMGI; 1 unit at 60 percent of AGMI; and 2 units at 80 percent of AMGI.

Table 1 to paragraph (g)(1)(i)(A)

Unit Number	Imputed Income Limitation of the Unit
1	80 percent of AMGI
2	80 percent of AMGI
3	60 percent of AMGI
4	40 percent of AMGI
5	40 percent of AMGI

(B) In the first taxable year of the credit period (Year 1), the project is fully leased and occupied.

(ii) Analysis. (A) The average of the imputed income limitations of the units is 60 percent of AMGI calculated as follows: (2 x 40% + 1 x 60% + 2 x 80%) / 5 = 60%.

(B) Thus, the income limitations satisfy the requirement in paragraph (a)(3) of this section that the average of the designated imputed income limitations of the low-income units in the project does not exceed 60% of AMGI.

(2) Example 2--(i) Facts. Assume the same facts as in paragraph (g)(1) of this section (Example 1). In Year 2, Unit # 4 becomes uninhabitable. (Unit # 4 has a designated imputed income limitation of 40 percent of AMGI.) Because all of the units in the project are low-income units, converting a market-rate unit to a low-income unit is not an available mitigating action. Within 60 calendar days following the close of Year 2, the taxpayer identifies Unit # 2 as a removed unit. (Unit # 2 has a designated imputed income limitation of 80 percent of AMGI.) Repair work on Unit # 4 is completed in Year 4, and the taxpayer then ends the status of Unit # 2 as a removed unit.

(ii) Analysis. During Year 2, Unit # 4 is not a low-income unit because it is not suitable for occupancy under section 42(i)(3)(B). In the absence of any mitigating action, the average of the imputed income limitations of the units at the close of Year 2 would be 65 percent of AMGI. That average would be calculated as follows: (1 x 40% + 1 x 60% + 2 x 80%) / 4 = 65%. Under paragraph (d)(2) of this section, unless effective mitigating action is taken not later than the 60th calendar day following the close of Year 2, the project fails to be a qualified low-income housing project because it fails to satisfy paragraph (a)(3) of this section. As described in the facts in paragraph (g)(2)(i) of this section, however, the taxpayer takes the mitigating action in paragraph (e)(2) of this section. That action has the following results:

(A) Average income test. Under paragraph (f)(2) of this section, the identification of Unit # 2 as a removed unit causes that unit not to be taken into account in computing the average of the imputed income limitations of the low-income units. Unit # 4 is also not taken into account because it is no longer a low-income unit. Therefore, the calculation under paragraph (a)(3) of this section as of the close of Years 2 and 3 is as follows: (1 x 40% + 1 x 60% + 1 x 80%) / 3 = 60%. Thus, for those years, the project satisfies the average income test because, for purposes of that test, at least 40 percent of the units are taken into account as low-income units and the average of the imputed income limitations of those units does not exceed 60% of AMGI.

(B) Recapture. At the close of Year 2, the amount of the qualified basis is less than the amount of the qualified basis at the close of Year 1, because Unit # 4's unsuitability for occupancy prohibits it from being a low-income unit. Unit # 4's failure to be a low-income unit, therefore, reduces the applicable fraction and thus the qualified basis as well. This results in a credit recapture amount for Year 2. Under paragraph (f)(2) of this section, however, for purposes of calculating the recapture amount, Unit # 2's status as a removed unit does not impair its contribution to the applicable fraction and the qualified basis.

(C) Restoration of habitability and of qualified basis. As described in the facts in paragraph (g)(2)(i) of this section, in Year 4, after repair work is complete, the formerly uninhabitable Unit # 4 is again suitable for occupancy, and the taxpayer ends the status of Unit # 2 as a removed unit. Thus, both units are now low-income units, neither is a removed unit, and so both are included in the computations for the average income test. At the close of Year 4, therefore, the average of the imputed income limitations of all of the low-income units in the project is 60 percent of AMGI, which is calculated as follows: (2 x 40% + 1 x 60% + 2 x 80%) / 5 = 60%. For purposes of computing the credit under section 42(a) for Year 4, both units are included in the applicable fraction and, thus, are included in qualified basis for purposes of that calculation. Prior to the restoration in Year 4, for purposes of a computation of credits under section 42(a), Unit # 4 does not contribute to qualified basis because it is not a low-income unit, and, under paragraph (f)(3) of this section, Unit # 2 does not contribute to qualified basis because it is a removed unit.

(h) Applicability dates. This section applies to taxable years beginning after [date these regulations are published as final regulations in the **Federal Register**].

Sunita Lough,

Deputy Commissioner for Services and Enforcement.

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